Supreme Court, U.S.
FILED
OCT 23 2000
CLERK

(2)

No. 00-459

In the Supreme Court of the United States

SALVADOR A. GAUDIANO, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

SETH P. WAXMAN
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation. During 1993, that corporation obtained a discharge of certain indebtedness. That discharge would have been treated as an item of "[i]ncome from discharge of indebtedness" (26 U.S.C. 61(a)(12)) except that, because the discharge occurred when the corporation was insolvent, the item is expressly "not include[d] * * * in gross income" under 26 U.S.C. 108(a)(1)(A). The question presented in this case is whether the amount thus expressly excluded from "income" is nonetheless to be treated as if it were an item of "income" which, under 26 U.S.C. 1366(a)(1)(A), flows through to petitioners as the shareholders of the Subchapter S corporation, thereby increasing their basis in the stock of the corporation under 26 U.S.C. 1367(a)(1)(A), and thereby allowing them to deduct losses they previously were unable to deduct because they had exhausted their basis by prior deductions.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Discussion	5
Conclusion	6

TABLE OF AUTHORITIES

Cases:

Bufferd v. *Commissioner*, 506 U.S. 523 (1993)	2
Gitlitz v. *Commissioner*, 182 F.3d 1143 (10th Cir. 1999), cert. granted, 120 S. Ct. 1830 (2000)	5, 6
Nelson v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999)	4
Witzel v. *Commissioner*, 200 F.3d 496 (7th Cir. 2000), petition for cert. pending, No. 99-1693	5

Statutes:

Internal Revenue Code (26 U.S.C.):

§ 61(a)(12)	2
§ 108	2, 4
§ 108(a)	4
§ 108(a)(1)(B)	2
§ 1366	2
§ 1366(a)(1)(A)	3, 4
§ 1366(d)(2)	3
§ 1367	2
§ 1367(a)(1)(A)	3, 4
§ 1367(a)(2)(A)	3
§ 1367(a)(2)(B)	3

In the Supreme Court of the United States

No. 00-459

SALVADOR A. GAUDIANO, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-29a) is reported at 216 F.3d 524. The opinion of the Tax Court (Pet. App. 30a-44a) is reported at 76 T.C.M. (CCH) 858.

JURISDICTION

The judgment of the court of appeals was entered on June 8, 2000. The petition for rehearing was denied on July 18, 2000 (Pet. App. 57a). The petition for a writ of certiorari was filed on September 21, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. During the 1993 taxable year, petitioners were shareholders in Four A Coal Co., a corporation that had elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. Pet. App. 3a. As this Court explained in *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993), Subchapter S of the Code implements "a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships."

In 1993, the Subchapter S corporation was discharged from $1,289,048 in debt. Pet. App. 3a. This amount would have represented "[i]ncome from discharge of indebtedness" to the corporation (26 U.S.C. 61(a)(12)) but for the fact that, at the time of the discharge, the corporation was insolvent. Because the corporation was insolvent, the debt discharge amount was expressly excluded from gross income under Section 108 of the Code, which specifies that "[g]ross income does not include any amount which * * * would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs when the taxpayer is insolvent." 26 U.S.C. 108(a)(1)(B).

b. Although Section 108 of the Code thus specifies that discharge of indebtedness is *not* an item of income for an insolvent corporation, petitioners claim that it should nonetheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax treatment of shareholders of a Subchapter S corporation. In particular, they specify that "items of income (including tax-exempt income), loss, deduction,

or credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)). The basic concepts reflected in these provisions are: (i) that the income earned (or loss incurred) at the corporate level is treated as if it were earned (or lost) at the individual level; and (ii) that basis adjustments are made to avoid a double tax on those earnings or a double benefit from those losses.

A shareholder may deduct losses only to the extent that he has not previously recovered (through prior deductions) his basis in the stock. 26 U.S.C. 1366(d)(2). In this case, petitioners had previously deducted losses representing their entire basis in the corporate stock. At the time the indebtedness of the Subchapter S corporation was discharged in 1993, petitioners would be allowed further deductions for the corporation's losses only if their basis in the stock of the corporation were somehow increased.[1]

Petitioners assert that the additional basis that would allow them to take further deductions for corporate losses can be found in the discharge of indebted-

---

[1] The losses incurred by the corporation which petitioners were unable to deduct because they had exhausted their basis in the stock of the corporation are described as "suspended" losses and are carried into future years. They may be deducted in future years only if the shareholder acquires a basis in the stock to apply against them. 26 U.S.C. 1366(d)(2).

ness "income" of the corporation in 1993. They assert that this discharge of indebtedness is an "item[] of income" (26 U.S.C. 1366(a)(1)(A)) which increases their basis in the corporate stock (under 26 U.S.C. 1367(a)(1)(A)) even though, for the reasons described above, Section 108(a) of the Code expressly states that this is "*not*" an item of income. Petitioners thus claimed additional deductions in an amount equivalent to their allocable share of the corporation's debt-discharge amount during 1993. Pet. App. 4a.

The Commissioner of Internal Revenue determined that petitioners were not entitled to increase their stock basis by the discharge of indebtedness that was "not" an item of income under Section 108 of the Code. The Commissioner therefore disallowed the claimed deductions and asserted deficiencies in tax against petitioners for the 1993 taxable year. Pet. App. 4a-5a.

2. Petitioners filed a petition in Tax Court to contest the Commissioner's determinations. The Tax Court held that the discharge of the corporation's indebtedness did not increase petitioners' basis in the corporate stock and that the claimed deductions were therefore properly denied. Pet. App. 35a-36a. In reaching that conclusion, the court relied on its reviewed decision in *Nelson* v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999), in which the court unanimously held that an amount excluded from an insolvent Subchapter S corporation's gross income under Section 108 does not increase a shareholder's basis in the corporate stock. Pet. App. 35a-36a.[2]

---

[2] The Tax Court also held that another Subchapter S corporation in which petitioners Gary and Larry Asher were shareholders was not entitled to a bad debt deduction for amounts advanced to Four A Corporation. Pet. App. 42a-44a. That holding was

3. The court of appeals affirmed. Pet. App. 1a-29a. In doing so, however, the court stated that it disagreed with the conclusion reached by the Tax Court in *Nelson* and the Tenth Circuit in *Gitlitz* v. *Commissioner*, 182 F.3d 1143 (1999), cert. granted, 120 S.Ct. 1830 (2000), "that [cancellation of debt] income is not income within the meaning of § 1366(a)(1)(A) and thus does not pass through to the shareholders and increase the basis of their shares." Pet. App. 23a-24a. Instead, in upholding the disallowance of the claimed deductions, the court adopted the reasoning of the Seventh Circuit in *Witzel* v. *Commissioner*, 200 F.3d 496 (2000), petition for cert. pending, No. 99-1693. The court concluded that petitioners' stock basis was not increased because "the corporation must determine its net operating losses and suspended operating losses for the year of discharge and reduce those attributes by the amount of [debt-discharge] income realized." Pet. App. 23a. The court concluded that, because the amount of the net operating losses involved in this case was "completely offset" by the amount of the discharged debt (*id.* at 24a), none of the losses flowed through to the shareholders "to use as deductions on their 1993 returns and the Tax Court's disallowance of the deductions is affirmed." *Id.* at 25a.

DISCUSSION

This case presents the same question presented in *Gitlitz* v. *Commissioner*, No. 99-1295, in which this Court heard oral argument on October 2, 2000. The petition in this case should therefore be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz*.

---

affirmed by the court of appeals (*id.* at 25a-28a) and is not challenged in the petition for a writ of certiorari.

CONCLUSION

The petition for a writ of certiorari should be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz* v. *Commissioner*, No. 99-1295.

Respectfully submitted.

SETH P. WAXMAN
Solicitor General

OCTOBER 2000